

Advertising Your Timber Sale

Tennessee Department of Agriculture, Division of Forestry

Excerpted from Oklahoma Extension Facts F-5035.

There are several steps to follow in preparing a timber sale notice. You must have accurate, reliable information and you need to send it to as many prospective bidders as possible. A professional forester can assist you with a list of reputable timber buyers. For additional advertisement of your timber sale, place an add in several area newspapers directing interested buyers to contact you for a complete description of the sale. A timber sale notice should include the basic information that will become part of the timber sale contract including:

- **Your name, address and phone number;** or the name address and phone number of the forester managing the sale.
- **The location of the timber to be sold.** Include a map and legal descriptions and directions for locating the area. Also, include how the sale boundaries will be marked.
- **A description of the trees or logs to be sold.** Include volume by species, diameter classes and sawlog grades if appropriate.
- **Type of bid you are expecting.** Either lump sum or scaled sale.
- **Type of sale.** Either sealed bid or unit sale.
- **Times when potential buyers can visit and inspect the timber sale area.** Usually, one month is allowed from the time notices are sent until the bids are opened.
- **The date, time and location when written bids will be opened.** Include how the successful bidder will be selected and notified.
- **Whether or not a down payment is required to bind the offer when the contract is signed.** An amount of 5 to 10 percent of the bid price is normally required.

- **Any limitations or special ownership considerations on the sale.** Such considerations include implementation of Best Management Practices. Harvesting deadline, restrictions on access, considerations when loggers cannot operate (i.e. excessively wet conditions), streamside management zones or buffers, snag or cavity leave trees, etc.
- **The requirement for a performance bond.** A performance deposit is an amount of money over and above the sale price (usually 10 percent of sale price) posted by the buyer when the contract is signed and held in escrow by the seller. The bond's purpose is to ensure that the buyer abides by the terms set forth in the contract. The performance deposit should be refunded immediately after the sale is completed and contract requirements are met
- **Evidence that the logger carries workman's compensation insurance** for all members of the logging crew and has adequate liability insurance. Workman's compensation insurance will avoid possible legal complications if a logger is injured on your property. Be sure to see the logger's workman compensation insurance and liability papers to make sure they are in effect.
- **Statement of the right to refuse all bids.**

You should also specify the length of time that will elapse before the successful bidder is notified, usually within seven days after the bids were opened. The amount of time the successful bidder has to respond should also be included. Normally, ten days are allowed for a yes or no response.

Selecting a Logger

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It is important for a landowner to select the right logger, one who:

- Has a reputation for honesty and good work
- Uses environmentally sound practices
- Will abide by the provisions of your contract
- Has the right equipment and skills to do the job
- Has proper safety equipment, places a high priority on safety and carries insurance

It is also important for the landowner to understand the pressures a logger faces:

- A huge investment in equipment,
- Breakdowns
- Highly competitive timber purchasing
- The risk that timber will not have the quality anticipated
- Shifting markets
- Wet weather, a high risk of injury, high insurance costs, and competition from less scrupulous loggers who use substandard practices or don't carry workers' compensation insurance.

The "good ol' boy" method is not the best way to pick a logger. Family and friends who log, or loggers recommended by them, often don't pan out. This can lead to hard feelings as well as damage to the land and financial loss.

A good place to start is to acquire a list of Master Loggers from the Tennessee Forestry Association (615-883-3832), your local Area Forester, or a forestry consultant. These loggers have completed a five-day training session that includes how to use the State's logging guides, or Best Management Practices (BMPs). Not only will following BMPs protect your land, it will help protect you from liability that can result from violation of State Water Quality Laws. Horse or mule loggers might not have had this training, but their method can have less impact on soil than tractors or skidders.

Talk to loggers personally and try to get a feel for their personality and values. Ask for several references, including landowners they have logged for and mills they have sold to. As you narrow down your choices, visit property they are logging or have just finished.

Questions to ask loggers:

- How long have you been in business?
- How long have the crew members worked for you?
- Do you carry workers' compensation and liability insurance? Can I see proof?
- What kind of equipment will you use? How does it match up with my site?
- Do you pre-plan skid trail locations?
- How will you protect "no-cut" trees?
- When and how would you cross a stream?
- What will my land look like after you're done?
- Do you sub-contract sales? How do you ensure quality?
- What BMPs do you normally use? Which would be important on my sale?
- How would you handle timber trespass?

Questions to ask references. Did the logger

- Make timely payments
- Fulfill verbal and written agreements?
- Communicate well, listen to concerns? answer questions, explain things?
- Seem flexible and responsive?
- Delay excessively?
- Avoid damaging trees and improvements?
- Restore, repair and clean up the site before leaving?
- Seem concerned about environmental matters?
- Stop or modify operations appropriately in wet weather?
- Would you have him cut your timber again? Why or why not?

Selling Timber

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Following these steps should assure a landowner of a fair price, protection of the land, proper tax treatment, and freedom from legal problems.

Keep good records for tax purposes and educate yourself about federal timber taxation. Most tax preparers and many IRS agents are unfamiliar with the rules, but most foresters are. Excellent web sites on this subject include www.southernregion.fs.fed.us/spf/taxtips/, www.web.com-taxtips, www.fnr.perdue.edu/ttax, www.irs.ustreas.gov, and [www.fs.fed.us/spf/coop/Forest%20 Tax %20Guide31201.pdf](http://www.fs.fed.us/spf/coop/Forest%20Tax%20Guide31201.pdf)

Get professional help. A State area forester can give you valuable advice, planning assistance, and a list of consulting foresters. Consulting foresters will work on your behalf to get top dollar while meeting your other objectives. The cost of the commission is well worth it.

Know what you have in terms of timber volume and quality. Quality (grade) makes a tremendous difference in price received. Only an expert can accurately determine grade.

Decide when to sell. Over the past few decades timber prices have risen on average about 5-10% per year, depending on grade and species. However, the timber market is cyclical, so try to wait out the lows and sell when prices are up. Also, consider the maturity of your timber. Is it too young or too old? Young timber is just entering its most productive years, but it is not yet worth much. Old timber may actually be losing volume.

Circumstances may sometimes dictate that you harvest timber immediately to salvage damaged timber and reduce the threat of loss from insects, disease or fire.

Consider other objectives and make a long-range plan for your land. Timber harvest is a great opportunity to improve your woods for decades to come. Prior to harvest, decide on important questions like regenerating the next stand and protecting your land's productivity.

Survey and mark boundaries to avoid disputes.

Decide on a sale method. You can sell by shares, pay-as-cut, or lump sum. The latter is usually best for the seller *when done by sealed bid* because competition generates higher prices. For a few sellers, pay-as-cut can offer decided tax advantages by allowing capital gains treatment. Negotiating a price and payment method may be appropriate where special sale conditions limit the number of interested and qualified bidders.

Invite bids and conduct a show-me tour. A consultant can handle this for you. Bid invitations should include a location map, date of tour, date/time & location of bid opening, terms of payment, timber volume summary, bid form, information about the performance bond, and a statement of the seller's right to refuse bids.

Open the bids & negotiate the contract with the highest *acceptable* bidder. Collect any deposit or performance bond agreed upon. Prepare a copy of the contract for the buyer as well as for yourself.

Prepare a contract to protect both buyer and seller. One of the most important elements in timber sale contracts is a verification of the seller's legal ownership of the timber to be sold and its freedom from liens or other encumbrances. The contract should also include a description of the timber for sale, the selling price, terms of payment, which timber will be cut and not, time allowed to cut and remove timber, and a requirement to follow Best Management Practices. Other provisions can be added, but these may restrict bidders and lower the price paid. Your forester or Extension agent can supply a sample contract

Inspect the logging operation often to be sure that the contract provisions are followed. A consulting forester can do this if desired.

Follow through by retiring the sale area and taking steps to assure future productivity. For example, install water bars and seed skid trails and landings, if not done by the contractor, and cut or deaden residual undesirable trees.

Suggested Items to Include in a Timber Sale Contract

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1. Name and address of buyer.
2. Date contract is executed.
3. Description of the timber: species, size, marking.
4. Location and legal description.
5. Statement that states seller's ownership and right to convey; should include title abstract and title insurance.
6. Provision for buyer's entrance into and exit from the property.
7. Statement that logger must stay within the marked area.
8. Care required of buyer toward property of seller.
9. Penalty for cutting non-designated timber and not cutting designated timber
10. Method of logging to be used.
11. Statement that buyer will use Best Management Practices.
12. Fire protection clause.
13. Method and terms of payment, including down payment
14. Duration of agreement (usually 12 to 24 months).
15. When logging will begin
16. Requirement that buyer notify seller of start and stop dates (7 to 10 days notice is often required).
17. Utilization standards: stump height, top diameter, etc.
18. Statement of who will suffer the loss if timber is stolen or destroyed.
19. Provision for or against assignment of contract to a third party (subcontractor).
20. Restriction of when logging can be done.
21. Landowner's right to inspect logging site and suspend operation if buyer is violating provisions of contract.
22. Detail steps buyer must take to be released from contract.
23. Penalties for non-performance, including setting up and escrow account.
24. Provision that frees seller from liability for injury, death or damage caused by the logger.
25. Statement that logger must show proof of having workman's compensation coverage and is not an employee of the seller.
26. Provision of a performance bond (usually 5 to 10% of sale price).
27. Provisions for logger's responsibility for repair of site: litter, seeding, clearing landings, repairing roads, etc.
28. Clause allowing for arbitration in case buyer and seller cannot agree on and issue.
29. Provision for or against renewal of contract.
30. Statement that any changes to the contract must be signed, dated and witnessed.
31. Signature of both parties.
32. Notarization of contract, preferably with two witnesses' signature.
33. Recording of contract at the county courthouse.

If your land is financed, the timber is probably covered by the mortgage and is part of the lender's collateral. You should work out an agreement with the lender prior to the sale. The lender could require that the proceeds be applied to the loan. The arrangement should be in writing.

You should consult your tax accountant (and/or consulting forester) concerning filing status and capital gains eligibility prior to planning the sale. If you sell timber frequently (every five years or so), you may be considered "in the timber business" by the IRS; as such, you must sell in accordance with IRS Code 631(a) and (b) to retain capital gains treatment, and must pay self-employment tax.

Introduction to Timber Taxation

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Forest tax regulations are complex and subject to change. Many IRS agents and accountants are unfamiliar with them, so it is usually up to landowners to educate themselves. The following brief checklist is intended only to alert the reader to certain important points.

It is important to establish a cost basis and keep it current. Cost basis is your investment in the timber. You can deduct the basis from your income when you sell the timber. Having a basis also allows you to claim a loss if the timber is destroyed suddenly and unexpectedly. A forestry consultant can help you establish a cost basis, even if the land was purchased years ago.

Capital gains are taxed at a much lower rate than regular income, and are exempt from the self-employment tax that must be paid on timber sales reported as ordinary income. You can also deduct your basis in the timber when it is sold, thus lowering your taxes.

Decide on your IRS status as a timber seller.

- Hobbyist
- Investor (many absentee owners fall in this category)
- Owner of a trade or business in which you do not actively participate
- Owner of a trade or business in which you actively participate

Each has advantages and disadvantages, depending on your situation. Active participation is the most desirable status for most taxpayers, since it allows for you to deduct timber management costs against income from any source. The IRS has six tests to help determine whether your management is active or passive:

1. you participated more than 500 hours
2. your effort was “substantially all” the activity
3. you did more than 100 hours, which was more than anyone else

4. all related activities of more than 100 hours that don’t of themselves meet the material participation test add up to more than 500 hours
5. you materially participated in five of the last 10 years
6. all facts & circumstances show you materially participated (not advisable)

Deductions. Many costs of owning, managing and selling timber may be deductible from your gross adjusted income, depending on your tax status and the nature of the expense. **Good records are important** for you and your tax accountant in claiming and defending deductions.

Reforestation tax credit and amortized

deductions. If you are growing timber for sale, you can deduct up to \$10,000 the first year and amortize the remainder over the next 8 years.

Greenbelt status, obtained through the county tax assessor, will reduce your property taxes.

Web Sites

National Timber Tax Web Site: www.timbertax.net

Tax Tips for Forest Landowners:
www.r8web.com/spf/

IRS publications and forms: www.irs.ustreas.gov

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Capital Gains, Timber Basis, Capital Accounts and Depletion

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Timber is considered a capital asset for taxpayers who qualify as “investors” or as “in the timber business” (which can include landowners who manage timber for profit). See Forestry information sheet “*Filing Status for Timber Sales*”.

The tax rate for long-term capital gains is 5% for the 10% and 15% brackets. Above the 15% bracket the rate is 15% - still low compared to the rates for ordinary income. No self-employment tax (15.3%) is paid on capital gains.

Besides providing a lower tax rate, capital gains treatment allows you to deduct the cost basis of the timber you are acquiring. Having a basis also allows you to claim a loss if the timber is destroyed by an unusual, unexpected and sudden cause (called a *casualty loss*), including fire, theft and storm.

Your *initial cost basis* is the fair market value of the timber on the first day of the year in which it was acquired, plus acquisition costs (cruise, survey, legal fees, etc). It does not include the cost of the land. A forester can assist you in establishing a cost basis retroactively from tree growth rates and old marketing reports. You do not have to establish a basis in order to get capital gains treatment.

To calculate a timber basis, first figure what percentage of FMV was contributed by timber, and then multiply that percentage by the purchase price. For example: say you buy land with a total FMV of \$150,000 including \$60,000 for 340 thousand board feet of timber; you paid \$170,000 total (including expenses) [Note: FMV, i.e., “appraised” value and sale price are seldom equal.]

1. $\$60,000/\$150,000 = .4$; that is, the timber makes up 40% of the FMV.
2. $40\% \text{ of } \$170,000 = \$68,000$ = the basis for the timber. Your depletion unit is $\$68,000/340,000 \text{ BF} = \200 per thousand board feet.

Each year, add any new capitalized costs (the cost of constructing permanent roads, reforestation costs not amortized under the special IRS 7-year amortization option) to your timber basis. Also add items you are depreciating. Each year, as you deduct depreciated costs from your income, also deduct the same costs from your timber account. The current total of costs in your timber account is called the *adjusted basis*.

The process of deducting your basis as you sell your timber is called *depletion*; the amount you can subtract per unit harvested is your *depletion unit*.

For example, you buy 10 acres of timberland for \$15,000. For simplicity let's assume that this is also its appraised fair market value (FMV). The timber was appraised at \$4,000, and the volume is 20,000 board feet. Your initial cost basis is the FMV of the timber (\$4,000), and the depletion unit is $\$4,000/20,000 = \200 per thousand board feet.

Often land sells for other than appraised fair market value. In that case you must allocate the purchase price between assets (land, timber, etc.) in proportion to the FMV of each.

When you get ready to sell timber, you can determine how much to deduct from your capital gains simply by multiplying the depletion unit times the volume sold.

For example, if you sell 5,000 board feet, and if your depletion unit is \$200 per thousand board feet, you can deduct $5,000 \times \$200/1,000 = \$1,000$.

It is important that you keep your timber account and volume up to date so that you have an accurate depletion unit when you sell. A pre-sale timber cruise will provide current volumes.

Separate accounts should be set up for

- land; this includes permanent road costs
- depreciable land improvements, including temporary roads, bridges, culverts, gravel, firebreaks and fences
- classes of equipment
- reforested areas and young timber. Any undepreciated expenses in these accounts are carried over to the timber account when the accounts are combined. Sub-accounts can also be set up for different stands of timber.

Report adjustments to basis and volume, and allowable basis deducted at time of sale, on Form T Schedule F; report timber sale profit on Form T Schedule C.

Tax Deductions and Depreciation

Tennessee Department of Agriculture, Division of Forestry

Landowners who can demonstrate a profit motive can deduct 1) capital costs (which form the cost basis of the property); 2) currently deductible expenditures for management and protection; 3) costs of sale.

Capitalized costs include items that are being depreciated, and costs that must remain in the capital account and be deducted from proceeds when the timber is sold. The latter include acquisition costs (cruise, survey, legal fees, etc.), construction of permanent roads, and reforestation costs not amortized under the special IRS 7-year amortization provision. Sale costs are also subtracted from timber sale revenue.

Currently deductible expenses can be deducted in the year they occur. To be deductible, expenses must be “ordinary and necessary costs” related to making a profit. These include carrying charges (property taxes and interest) and operating costs not related to a capital project: consultant and professional fees, hired labor, non-commercial silvicultural expenses, protection costs, travel expenses necessary for managing the land for a profit, tools with a life of less than a year and costing less than \$100, routine equipment maintenance, etc.

Filing status determines how currently deductible expenditures are treated:

- An investor can deduct expenses which, when aggregated with all other “miscellaneous itemized deductions” exceed a 2%-of-adjusted gross income floor from income from any source. Exceptions are property taxes, which are fully deductible against income from any source, and interest, which is deductible against net investment income (2% floor does not apply). Alternatively, investors can capitalize expenses (see below). In this way

expenses can be recovered when the timber is sold.

- A “passive” business manager can deduct all currently deductible expenses, but only against passive income; unused deductions can be carried forward indefinitely and applied to future passive income
- An “active” business manager can deduct all currently deductible expenses from income from any source.

See Forestry information sheet, *“Filing Status for Timber Sales”* for criteria.

Landowners can elect to capitalize carrying charges and operating costs. Carrying charges can be elected annually, but election to capitalize operating costs (such as timber stand improvement) must remain in effect until the management is completed. Carrying charges cannot be capitalized if the land is developed (built on), nor can they be capitalized in any year the land produces income.

Investors report deductions (above 2% floor) on Form 1040 Schedule A; businesses report deductions on Schedule C, and farmers on Schedule F. Notify the IRS of the election to capitalize carrying charges and operating expenses on a plain piece of paper.

Depreciation is accomplished by annually deducting the allowable amount for that year from both gross income and the capital account. Depreciable property includes office equipment, vehicles, tractors and similar equipment, tools with a life greater than a year and costing more than \$100, fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads.

Property is depreciated according to a schedule set by the IRS for that item. Tables are found in IRS Publication 946, *How to Depreciate Property*. The most commonly used set of IRS depreciation tables

is the Modified Accelerated Cost Recovery System, or MACRS. To select a table, you must know the placed-in-service date, the convention used for that item, and the depreciation method.

The most common methods are the 200% declining balance over the General Depreciation System recovery period (for non-farm) and the 150% declining balance over the GDS period method (for farms). See IRS tables in Publication 946.

“Convention” can be mid-year, mid-quarter or mid-month, but usually mid-year. Under the half-year convention, only half a year’s deduction is taken in the first and last years; this stretches the basis recovery period over an added tax year. *(Note: If more than 40% of an item that would normally be depreciated using the half-year convention is placed in service during the fourth quarter, it must be depreciated using the half-quarter convention.)*

Recovery periods:

- Basis recovered over **five** years: computers, light trucks, portable sawmills, copiers, logging machinery and road building equipment used by loggers and sawmillers for their own account
- Basis recovered over **seven** years: office furniture and equipment, farm fences
- Basis recovered over **15** years: bridges, culverts, non-farm fences, temporary roads, permanent road surfaces

Under Section 179, up to \$25,000 of expenditures (after 2002) can be deducted in the year the money was spent. For example, if you purchase a truck for \$20,000 you can deduct it entirely in the year purchased without having to amortize it over a five-year period. An item must be used more than 50% in the business to qualify for Section 179 treatment. Elect Section 179 treatment on Form 4562.

Listed items are things commonly used both at home and in the business. Listed items include cars, computers, cell phones, etc. Deductions must be in proportion to business versus personal use. For example, if a truck is used 60% for the business, the annual deduction listed in the IRS tables must be

multiplied by 0.6. If an item is used in the business less than half the time, it can no longer be depreciated by the 200% or 150% methods, and instead must be depreciated using the straight-line method (see IRS tables). It is important to keep detailed records of use of listed items.

Maintenance is a deductible expense, but repairs that increase the value or lengthen the life of equipment must be capitalized.

A “units of production” method may be elected for temporary roads. Amortized costs are allocated proportionate to the units removed in a given year divided by the total number of units removed.

You cannot capitalize both road construction and the equipment used in construction. Equipment amortization for the period it is used must be entered into the capital account for the road.

Assets depreciated using the same method and convention can be grouped together for accounting purposes. Write “general asset allocation made under Section 168(i)4” on the top of Form 4562.

If you sell depreciated property, the amount received for the depreciated item, up to the depreciated amount, is recaptured as ordinary income; money you receive above the depreciated amount is taxed as a capital gain.

Use Form 4562 section II to classify property and take the first deduction for property placed in service the previous year; use section III for deductions for property placed in service during prior years; use section V to document business use and calculate deductions for listed property.

See IRS publications 946 “How to Depreciate Property”, 225 “Farmers Tax Guide”, and 334 “Tax Guide for Small Business”.

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Filing Status for Timber Sales

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How you report a timber sale and whether you get capital gains treatment depends on whether you qualify as a hobbyist, investor, passive manager or active manager.

Hobbyists do not own their land primarily to produce a profit from timber. They must report any timber sales as ordinary income and can deduct sale expenses from sale proceeds in the year of sale.

To qualify as an investor or business, the landowner must demonstrate a profit motive for holding land. This can be done by having a current forest management plan, projecting future profits, participating in activities related to timber growth and sales, etc.

Investors have a profit motive for owning timber, but they sell timber infrequently, do not participate actively in timber management, and do not own their timber as part of a trade or business. Many absentee landowners fall into this category.

Investors can get capital gains treatment by selling timber using any method. Investors can deduct expenses against any source of income, above a 2% floor. All deductions below this 2% threshold are lost. Alternatively, investors can capitalize all expenses and recover them when the timber is sold. Investors can deduct property taxes from income from any source, and can deduct interest from investment income. Investors, like businesses, can deduct casualty losses from any source of income. Investors don't pay self-employment tax on cost share payments, while businesses do.

Persons are considered "in the timber business" if they are more active in their management than investors, if they sell timber fairly regularly, or if they own the timber as part of a trade or business. Growing and harvesting timber, as in a Tree Farm, can qualify as being in the timber business.

To get capital gains treatment, businesses must sell timber under the provisions of Section 631(a) or 631(b), which means they cannot sell by lump sum and still claim capital gains.

"Passive" managers are more involved in managing than are investors, but less involved than active managers. Passive managers can deduct all expenses, but only against passive income. However, they can carry forward unused

deductions indefinitely and apply them against future timber sale income.

"Active" manager status is generally the most advantageous, since active managers can deduct expenses against income from any source.

The IRS "passive loss rules" are the standard by used to determine whether you qualify as an active or passive manager. To qualify, your participation must be "regular, continuous and substantial" as defined by the following tests:

1. you spent more than 500 hours per year managing the business, or
2. you conducted substantially all the management activities related to the business, or
3. you participated for more than 100 hours and no one participated more, or
4. your participation in "significant activities" exceeded 500 hours (a significant activity is one where your participation exceeds 100 hours but doesn't in itself meet a material participation test).
5. you materially participated (were consider an "active" manager) in 5 of the last 10 years, or
6. all the facts and circumstances indicate that your participation was regular, continual and substantial (this test should not be relied upon)

As a general guide, if you spend less than 100 hours per year managing your forest and if you hire a manager, you will not qualify for active status.

(Note: retired or disabled persons may be exempt from the passive loss rule under Section 2032(a) if their land qualifies as a farm business; they need only be involved in making major decisions.)

Those who qualify as active or passive business managers must sell in accordance with IRS Code Section 631(a) or 631(b) in order to qualify for capital gains. (See Forestry Information Sheet "*Timber Sales Qualifying for Capital Gains Treatment*").

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Installment Sales of Timber

Tennessee Department of Agriculture, Division of Forestry

You can lessen the tax burden of a timber sale by spreading the payment out over more than one tax year by means of installment payments. The only requirement is that at least one payment be received after the year of sale; no payment is required in the year of sale.

“Pay-as cut” (shares) sales qualifying for capital gains under Section 631(b) are not considered installment sales. Lump sum sales can qualify as installment sales whether or not they qualify for capital gains; pay-as-cut sales qualify only if they are considered ordinary income.

Calculate each payment by prorating the gross profit (sale price minus basis and expenses) over the period when payments are received. Add interest, if any, to each payment.

If the sale price is over \$3,000, any payments due more than 6 months after the sale date must include interest payments. The interest rate used is the lower of 9% compounded semi-annually or the government test interest rate, published each month by the IRS. Call the IRS toll-free number to find the current rate for your area.

Interest payments are ordinary income.

File a Form 6265 in the year of sale and in every year thereafter that a payment is received. Report income in the year received. You can elect out of an installment sale by not filing a Form 6265 and paying the entire tax in the year of sale on the amount you are to receive; report the total income on Form 1040 Schedule C (for investors) or Form 4797 (for businesses)

Escrow sales generally do not qualify as installment sales.

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Reforestation Deduction

Tennessee Department of Agriculture, Division of Forestry

Landowners may qualify to deduct their reforestation expenses.

To qualify, the landowner must plant at least one acre, and the purpose must be to make money by selling timber. The cost share program must also be approved as excludable by the IRS. Most federal cost share programs are. Ask your forester.

You may deduct the first \$10,000 of reforestation in the first tax year, and then amortize (deduct) the remainder over a period of 8 years. Due to the “half-year convention”, you must claim half of one of the seven payments the first year, and the other half in year eight.

For example, say you spend \$13,800 on reforestation. You deduct \$10,000 the first year.

Divide \$3,800 by 7 years = \$542.86.

The first and last years are “half years”, so divide one payment by 2 = \$271.43.

So the first year you claim a deduction of \$271.43; in years 2 through 7 you claim \$542.86, and in the last year you claim \$271.43

An alternative to counting cost share payments as income and deducting them is to elect to exclude cost share payments from your income, but if you do you can't deduct them.

The amount you can exclude from income is determined as follows:

1. Select the higher of (a) the 3-year average of income/a defensible interest rate; (b) \$2.50 x the number of acres/ the interest rate
2. Compare this higher number to your cost share payment; the lesser of those two is the amount you can exclude

Persons qualifying as “businesses” must pay self-employment tax on cost share payments; investors do not have to.

Include a description of the species planted, the amount planted, the reason for planting, the date(s), and the location.

Enter the amount amortized on any given year on Form 4562, Depreciation and Amortization.

Investors carry this over to Form 1040 line 32 as an adjustment to gross income (it is not entered on Schedule A as an itemized deduction). Write “reforestation” on line 32.

Sole proprietors carry over the amortized amount to Form 1040, Schedule C (Business Schedule) part V, “other expenses”. Enter “carried over from Form 4562.” Farmers carry over to Form 1040, Schedule F, Part II, “other expenses”.

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Timber Casualty Losses

Tennessee Department of Agriculture, Division of Forestry

Timber lost by fire, storm, theft, and in some cases drought may be fully deductible from adjusted gross income. This includes investors and passive participants as well as active participants.

Fire, storm and theft are called “casualty losses”. Casualty losses must be abnormal, unusual and unexpected. Similar losses, called non-casualty losses, may also be deductible if they are unusual and abnormal, but not unexpected. Non-casualty loss might result from a southern pine beetle epidemic or death of seedlings because of drought. Losses resulting from ordinary circumstances are not deductible.

Your deductible loss is the lesser of the fair market value (FMV) and the basis of the timber suffering the loss, which the IRS calls the “single identifiable property” (SIP). It is to your advantage to use the entire stand of timber as the SIP. This affords the greatest chance of claiming the full Fair Market Value as a loss. It may be necessary to get a cruise to get a sound estimate of changes to the timber basis and FMV due to loss and damage.

You can claim a loss of *unmerchantable* timber if you maintain separate accounts for plantation and timber, if you allocate “reasonable” costs to these accounts, and if the costs have not already been transferred to the timber account.

You must attempt a salvage and be able to prove it; keep a record of buyers contacted and their responses.

If you can't complete the salvage in time to report, go head and file based on an estimate; adjust the return for the year when the amount is finally determined.

You must subtract what you get from a salvage sale, even if you haven't received the money yet. Adjust later tax returns if the amount received is different than anticipated.

If you have capital gains for the year, you must follow the capital gains/losses netting procedure proscribed by the IRS to determine your final loss or gain for the year.

Report gains or losses from the incident just as you would a timber sale; report casualty losses on Form 4684, Section B and carry over to Form 4797, Sale of Business Property. Report non-casualty losses as a Section 1231 involuntary conversion on Form 4797.

If your loss is not deductible, adjust your timber volume account but don't change the timber value account (cost basis) since you did not recover any basis.

In case of audit, provide added information on form 4748; it is a good idea to have this available ahead of time. Documentation is very important; it is advisable to take photos.

Tax payment can be postponed two years while you acquire replacement property; this includes reforestation.

See IRS Publication 547 (Sales and Other Dispositions) and 549 (Casualties, Disasters and Thefts) and IRS Code Section 1231, Involuntary Conversions.

This bulletin is educational in nature and is not intended to serve as specific advice on tax preparation.

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Timber Sales Qualifying for Capital Gains Treatment

Tennessee Department of Agriculture, Division of Forestry

To qualify for long-term capital gains treatment, timber owners must own their timber primarily for profit, hold it for more than a year and, if they are considered “in the timber business”, sell according to IRS Section 631(a) and (b). (*See Forestry Information Sheet on filing status*).

Section 631(a) allows the timber owner to elect capital gains treatment of income from timber he cuts himself. The IRS terms Section 631(a) “electing to treat the cutting as a sale”. Section 631(a) income is divided between capital gains and ordinary income. The capital gain is determined by subtracting the basis and sale expenses from the fair market value as of the beginning of the tax year. The ordinary income is the price received for the harvested timber minus the fair market value of the stumpage.

Section 631(b) provides capital gains treatment for sale of stumpage with an “economic interest retained”. This precludes selling by lump sum. In a lump sum sale, the buyer owns the uncut timber, so the seller no longer retains an “economic interest” in it. Timber sold under 631(b) must be cut “on shares” or on a per-unit basis for the seller to retain an economic interest.

Those who qualify as “investors” can sell timber by any method, including lump sum, and get capital gains treatment on the sale.

Often, selling by sealed bid using the lump sum method will bring the highest price. An attorney can write a carefully worded 631(b) contract that is essentially a lump sum sale presented as a shares sale with an economic

interest retained. The contract should contain the terms “lessor” and “lessee” to avoid any appearance of a lump sum sale.

Investors report timber income on Form T, Schedules C and F, and on Form 1040 Schedule D.

631(b) sales are similarly reported on Form T, Schedules C and F, Form 1040 Schedule D, and on Form 4797, Sale of Business Property. The buyer is required to supply the seller with a Form 1099.

631(a) sales are reported in two segments, one for capital gains and one for ordinary income. Capital gain is reported on Form 4797 Part I and on Form 1040 Schedule D; ordinary income is reported on Form 4797 part II and on Form 1040, Schedule C (business schedule). Again, Form T, Schedules C and F are filed. List expenses, including fair market value, as “other expenses” on 1040 Schedule C. Give the details of the sale on Form T Schedules C & F or on a plain piece of paper; include how depletion basis and fair market value were determined. Elect to file as a 631(a) sale on Form T, Schedule F. Once made, this decision cannot be changed without permission of the Commissioner of the Internal Revenue Service.

This document is educational in nature and is not intended to serve as tax advice or to take the place of a professional tax accountant.

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Timber Estimation Shortcuts

Tennessee Department of Agriculture, Division of Forestry

Basal area/acre (combined surface of the imaginary 4.5' tall "stumps" of merchantable trees) can be estimated by holding a penny at eye level 25 inches from the eye and turning slowly in a circle. If the penny appears wider than a tree trunk, don't tally that tree. If the penny appears to fit between the edges of the trunk, count the tree. Each counted tree represents 10 square feet of basal area, no matter how large or small the tree is. The penny is a cheap substitute for a 10 Basal Area Factor (BAF) prism. Keep the prism or penny, not your feet, at the center of the circle as you turn. The following shortcuts are based on a 10 BAF prism (or penny).

board foot volume of sawtimber = # 16' logs X 400 (Doyle rule) #16' logs X 600 (International rule.)

hardwood pulpwood in cords per acre = 4' sticks X .3

Hardwood pulpwood in **tons** = # 4' sticks X .9. (Or easier, # sticks - .1 (# sticks.)

Pine pulpwood in cords per acre = $\frac{1}{2}$ average tree height X counted trees per plot, divided by ten.

Pine in **tons** per acre = average height X basal area X .013.

Conversion factors (close approximations)

A cord of hardwood weighs 2.9 tons.

A cord of pine weighs 2.675 tons.

To convert board foot volume International Rule to Doyle Rule: divide International by 1.32

To convert Cedar Rule (2/3) to Doyle Rule: divide by 1.33

To convert tons of merchantable logs to volume Doyle Rule:

Hardwood = 9 tons/MBF

Pine = 7 $\frac{1}{2}$ tons/MBF

Cedar = 7.32 tons/MBF Doyle,
5 $\frac{1}{2}$ tons/MBF Cedar Rule

There are 6.04 BF in one cubic foot of wood

Compound interest

- ◆ Years needed to double value = $\frac{72}{\text{interest rate}}$
- ◆ Interest rate needed to double money in X years = $\frac{72}{X}$

Squaring numbers

Many times you need to square a number quickly in your head, such as when estimating the Doyle volume of a log:

$$V = (D-4)^2 (\text{length}) / 16.$$

To square a number, subtract to get a number ending in 0. Then add the same amount to the number you are squaring. Multiply these two together, then add the square of the number you subtracted (and added on.) Example: $23^2 = (23-3)(23+3) + (3 \times 3) = 20 \times 26 + 9 = 529.$

Version 10/03

When to Harvest Hardwood Sawtimber

Tennessee Department of Agriculture, Division of Forestry

Landowners too often sell their timber when it is in the midst of rapidly adding valuable wood. On the other hand, some landowners hold their timber past its prime and lose wood to breakage, decay, disease, insects and decline. When is the best time to sell hardwood timber, financially speaking?

The first step is to determine whether your trees have potential to increase much in value. Harvest all trees and start over if the present trees

- Are slow-growing or non-commercial species – beech, hickory, elm, sweetgum, blackgum etc.
- Have defective stems -scar at base, major limb in first 17 foot log, lightning scar, large rotten limb just above the first log, crooked etc.
- Are stunted and slow growing (for the site)

Vigorous trees tend to have long sweeping branches like fishing poles and are clearly growing rapidly upward. Stunted trees tend to have crooked spreading branches and flattened crowns.

If you are satisfied that the majority of your trees are healthy and of commercial species, you are ready to consider the profitability of leaving them to grow vs. harvesting now.

Before explaining the details, the bottom line is that it is most profitable to leave hardwood timber on good sites until it is 18" to 28" in diameter.

Now, the details. There are three sources of value increase: **growth, rising timber prices and grade increases.**

Growth. Generally, *vigorous* poletimber and sawtimber on *good sites* has the potential to increase in volume by 6 to 8% per year.

Rising timber prices. Over the past few decades, timber prices have increased at 4 to 6% per year after inflation is taken into account (better grades and species have increased more in price).

Grade. It is obviously foolish to cut fast growing poletimber for pulpwood when it will be worth much more as timber in just a few years. The same principle applies to small sawtimber – it rapidly grows into higher-grade sawlogs and veneer if it is relatively free of defects. Economic analysis shows that trees should be left if they have the potential to jump in grade.

If there is little prospect of grade increase in your trees, here are some factors to consider in deciding when to harvest:

- Leave trees longest on the best sites (deep, moist but well drained loamy soil)
- Good diameter growth will yield high increases in value
- Merchantable height increases will yield only slight increases in value
- Large trees of good vigor produce the highest dollar gains, but produce lower gains figured as a percentage of tree value. (In other words, you have a large "investment" tied up in the wood-producing "machinery" of the tree)
- What rate of return do you want?
 - If you demand a high rate (say more than 6%), cut trees sooner (say, 18 to 20 inches)
 - If you are satisfied with a low rate (say 2-4%) you can leave trees longer (say, up to 28 inches)

To calculate what your return will be, use the formula

$$\text{Present Value} = \text{Future Value} / (1+i)^{\text{years}}$$

$$\text{Or } i = \sqrt[\text{years}]{(\text{Future Value} / \text{Present Value})} - 1$$

1. Look up the number of board feet in your tree(s) in a volume table (the bottom 16' log is the most important)
2. Measure the growth rate of your tree(s) with an increment borer (do not bore into the merchantable part of high-quality logs)
3. Figure what the diameter will be in "y" years and look up that volume
4. Calculate dollar values based on, say, the Tennessee Department of Agriculture Forest Products Marketing Bulletin
5. Calculate $\sqrt[\text{years}]{(\text{Future Value} / \text{Present Value})} - 1$

Example: Present Value of tree = \$100

Value in 5 years expected to be \$147

$$i = \sqrt[5]{147/100} - 1$$

$$i = \sqrt[5]{147} - 1$$

$$i = 1.08 - 1$$

$$i = .08 = 8\% \text{ annual interest}$$

Scientific calculators have a \sqrt{x} key. An inverse key (INV) can also be used.

Timber price trends can easily be figured in. In this example, if timber prices are increasing at 6% per year, then your timber is yielding $8\% + 6\% = 14\%$ annually. Any increases in grade will raise this rate further.